The Economist

THE GREAT DISRUPTION

How business is coping with turbulent times

Adrian Wooldridge

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Taking flight

On September 17th 2009, *The Economist* launched a new business column. Why call it Schumpeter?

THERE IS SOMETHING ABOUT BUSINESS that prevents most people from seeing straight. The rise of modern business provoked relentless criticism. Anthony Trollope featured a fraudulent railway company in *The Way We Live Now* (1875). Upton Sinclair dwelt on "the inferno of exploitation" in Chicago's meat packing industry in *The Jungle* (1906). Muckraking journalists denounced the titans of American business as "robber barons".

A striking number of business people accepted this hostile assessment. Friedrich Engels used some of the profits of his successful textile business to support Karl Marx, the self-proclaimed gravedigger of capitalism. Henry Frick's last message to his fellow steel magnate, Andrew Carnegie, was "Tell him I'll see him in hell, where we both are going." Many of the greatest business people threw themselves into philanthropy to try to win back the souls that they had lost in making money. Anti-business sentiment is still widespread today. For many environmentalists, business is responsible for despoiling the planet. For many apostles of corporate social responsibility, business people are fallen angels who can only redeem themselves by doing good works.

But anti-business sentiment is not as pervasive as it once was, thanks to the Thatcher-Reagan revolution and the collapse of communism. Instead there is new irritation to contend with – the blandification of business. Companies are at pains to present themselves as warm-and-fuzzy global citizens. Politicians praise businessmen as job creators. The United Nations and the World Bank celebrate businesses as all-purpose problem-solvers. Nicolas Sarkozy makes a distinction between business people (who create things) and financial speculators (who wreak havoc).

Joseph Schumpeter was one of the few intellectuals who saw business straight. He regarded business people as unsung heroes:

men and women who create new enterprises through the sheer force of their wills and imaginations, and, in so doing, are responsible for the most benign development in human history, the spread of mass affluence. "Queen Elizabeth [I] owned silk stockings," he once observed. "The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily decreasing amounts of effort …The capitalist process, not by coincidence but by virtue of its mechanism, progressively raises the standard of life of the masses." But Schumpeter knew far too much about the history of business to be a cheerleader. He recognised that business people are often ruthless monomaniacs, obsessed by their dreams of building "private kingdoms" and willing to do anything to crush their rivals.

Schumpeter's ability to see business straight would be reason enough to name a business column after him. But this ability rested on a broader philosophy of capitalism. He argued that innovation is at the heart of economic progress. It gives new businesses a chance to replace old ones, but it also dooms those new businesses to fail unless they can keep on innovating (or find a powerful government patron). In his most famous phrase he likened capitalism to a "perennial gale of creative destruction".

For Schumpeter the people who kept this gale blowing were entrepreneurs. He was responsible for popularising the word itself, and for identifying the entrepreneur's central function: of moving resources, however painfully, to areas where they can be used more productively. But he also recognised that big businesses can be as innovative as small ones, and that entrepreneurs can arise from middle management as well as college dorm-rooms.

Schumpeter was born in 1883, a citizen of the Austro-Hungarian empire. During the 18 years he spent at Harvard he never learned to drive and took the subway that links Cambridge to Boston only once. Obsessed by the idea of being a gentleman, he spent an hour every morning dressing himself. Yet his writing has an astonishingly contemporary ring; indeed, he seems to have felt the future in his bones. The gale of creative destruction blew ever harder after his death in 1950, particularly after the stagflation of the 1970s. Corporate raiders and financial engineers tore apart underperforming companies.

Governments relaxed their hold on the economy. The venture-capital industry exploded, the computer industry boomed and corporate lifespans shortened dramatically. In 1956–81 an average of 24 firms dropped out of the *Fortune* 500 list every year. In 1982–2006 that number jumped to 40. Larry Summers argues that Schumpeter may prove to be the most important economist of the 21st century.

A prophet and a role model

The prophet of capitalism's creative powers also understood the precariousness of the capitalist achievement. He pointed out that successful firms depend upon a complex ecology that has been created over centuries. He wrote extensively about the development of the joint-stock company and the rise of stockmarkets. He also understood that capitalism might be destroyed by its own success. He worried that a "new class" of bureaucrats and intellectuals were determined to tame capitalism's animal spirits. And he warned that successful business people were always trying to conspire with politicians to preserve the status quo.

Schumpeter was far from infallible. His ideas about long business cycles have not withstood the test of time. He was too sceptical about the case for using government spending to avert depressions. He underestimated the self-correcting power of democracy. But, 65 years after his death, this great champion of innovation and entrepreneurship surely got as close as anybody to identifying what a column on modern business should be about.

September 2009

Remembering Drucker

Peter Drucker remains the king of the management gurus

IN THE NORMAL RUN of things the management world is divided into dozens of mutually suspicious tribes – theoreticians versus practitioners, publicity-hogging gurus versus retiring academics, supporters of "scientific" management versus advocates of the "humanistic" sort. But in November 2009 there was unusual comity: the leaders of all the management tribes came together to celebrate the centenary of the birth of Peter Drucker, a man who is often described as "the father of modern management" and "the world's greatest management thinker".

The celebrations took place all around the world, most notably in Vienna, where Drucker was born, in southern California, where he spent his golden years, and in China, where he is exercising growing influence. The speakers were not limited to luminaries of management: they also included Rick Warren, the spiritual guru of the moment in America, Frances Hesselbein, a former head of the American Girl Scouts, and David Gergen, an adviser to both Republican and Democratic presidents.

To mark the centennial, *Harvard Business Review* put a photograph of Drucker on its cover along with the headline: "What Would Peter Do? How his wisdom can help you navigate turbulent times". Claremont Graduate University in California, where Drucker taught, boasts not one but two institutions that are dedicated to keeping the flame alive: the Peter Drucker and Masatoshi Ito Graduate School of Management and the Drucker Institute. The institute acts as the hub of a global network of Drucker societies that are trying to apply his principles to everything from schools to refuse collection. It also produces a "do-it-yourself workshop-in-a-box" called "Drucker Unpacked".

Why does Drucker continue to enjoy such a high reputation? Part of the answer lies in people's mixed emotions about management. The management-advice business is one of the most successful industries of the past century. When Drucker first turned his mind to the subject in the 1940s it was a backwater. Business schools were treated as poor relations by other professional schools. McKinsey had been in the management-consulting business for only a decade and the Boston Consulting Group did not yet exist. Officials at General Motors doubted if Drucker could find a publisher for his great study of the company, *Concept of the Corporation*, on the grounds that, as one of them put it, “I don’t see anyone interested in a book on management.”

Today the backwater has turned into Niagara Falls. The world’s great business schools have replaced Oxbridge as the nurseries of the global elite. The management-consulting industry earns revenues of hundreds of billions a year. Management books regularly top the bestseller lists. Management gurus can command $60,000 a speech.

Yet the practitioners of this great industry continue to suffer from a severe case of status anxiety. This is partly because the management business has always been prey to fads and fraudsters. But it is also because the respectable end of the business seems to lack what Yorkshire folk call “bottom”. Consultants and business-school professors are forever discovering great ideas, like re-engineering, that turn to dust, and wonderful companies, like Enron, that burst into flames.

Peter Drucker is the perfect antidote to such anxiety. He was a genuine intellectual who, during his early years, rubbed shoulders with the likes of Ludwig Wittgenstein, John Maynard Keynes and Joseph Schumpeter. He illustrated his arguments with examples from medieval history or 18th-century English literature. He remained at the top of his game for more than 60 years, advising generations of bosses and avoiding being ensnared by fashion. He constantly tried to relate the day-to-day challenges of business to huge social and economic trends such as the rise of “knowledge workers” and the resurgence of Asia.

But Drucker was more than just an antidote to status anxiety. He was also an apostle for management. He argued that management is one of the most important engines of human progress: “the organ that converts a mob into an organisation and human effort into performance”. He even described scientific management as “the most powerful as well as the most lasting contribution America has made to Western thought since the 'Federalist Papers'." He relentlessly extended management's empire. From the 1950s onwards he offered advice to Japanese companies as well as American ones. He insisted that good management was just as important for the social sector as the business sector. He acted as an informal adviser to the Girl Scouts. He helped inspire the mega-church movement. The management school that bears his name recruits about a third of its students from outside the business world.

Scout's honour

The most important reason why people continue to revere Drucker, though, is that his writing remains startlingly relevant. Reading *Concept of the Corporation*, which was published in 1946, you are struck not just by how accurately he saw the future but also by how similar today's management problems are to those of yesteryear. This is partly because, whatever the theorists like to think, management is not a progressive science: the same dilemmas and difficult trade-offs crop up time and again. And it is partly because Drucker discovered a creative middle ground between rival schools of management. He treated companies as human organisations rather than just as sources for economic data. But he also insisted that all human organisations, whether in business or the voluntary sector, need clear objectives and hard measurements to keep them efficient. Drucker liked to say that people used the word guru because the word charlatan was so hard to spell. A century after his birth Drucker remains one of the few management thinkers to whom the word "guru" can be applied without a hint of embarrassment.

November 2009

Why do firms exist?

Ronald Coase, a Nobel prize-winning economist, asked the most fundamental question about business

FOR PHILOSOPHERS the great existential question is: "Why is there something rather than nothing?" For management theorists the more mundane equivalent is: "Why do firms exist? Why isn't everything done by the market?"

Today most people live in a market economy, and central planning is remembered as the greatest economic disaster of the 20th century. Yet most people also spend their working lives in centrally planned bureaucracies called firms. They stick with the same employer for years, rather than regularly returning to the jobs market. They labour to fulfil the "strategic plans" of their corporate commissars. John Jacob Astor's American Fur Company made him the richest man in America in the 1840s. But it never consisted of more than a handful of people. Today Astor's company would not register as a blip on the corporate horizon. Firms routinely employ thousands of workers and move billions of dollars-worth of goods and services within their borders.

Why have these "islands of conscious power" survived in the surrounding "ocean of unconscious co-operation", to borrow a phrase from D.H. Robertson, an economist? Classical economics had little to say about this question. Adam Smith opened *The Wealth of Nations* with a wonderful description of the division of labour in a pin factory, but he said nothing about the bosses who hired the pin-makers or the managers who organised them. Smith's successors said even less, either ignoring the pin factory entirely or treating it as a tedious black box. They preferred to focus on the sea rather than the islands.

Who knows the secret of the black box?

The man who restored the pin factory to its rightful place at the heart of economic theory celebrated his 100th birthday on December

29th 2010. The economics profession was slow to recognise Ronald Coase's genius. He first expounded his thinking about the firm in a lecture in Dundee in 1932, when he was just 21 years old. Nobody much listened. He published *The Nature of the Firm* five years later. It went largely unread.

But Mr Coase laboured on regardless: a second seminal article on "The Problem of Social Cost" laid the intellectual foundations of the deregulation revolution of the 1980s. Eventually, Mr Coase acquired an army of followers, such as Oliver Williamson, who fleshed out his ideas. In 1991, aged 80, he was awarded a Nobel prize. Far from resting on his laurels, Mr Coase published a new book in 2011, with Ning Wang of Arizona State University, on "How China Became Capitalist".

His central insight was that firms exist because going to the market all the time can impose heavy transaction costs. You need to hire workers, negotiate prices and enforce contracts, to name but three time-consuming activities. A firm is essentially a device for creating long-term contracts when short-term contracts are too bothersome. But if markets are so inefficient, why don't firms go on getting bigger for ever? Mr Coase also pointed out that these little planned societies impose transaction costs of their own, which tend to rise as they grow bigger. The proper balance between hierarchies and markets is constantly recalibrated by the forces of competition: entrepreneurs may choose to lower transaction costs by forming firms but giant firms eventually become sluggish and uncompetitive.

How much light does *The Nature of the Firm* throw on today's corporate landscape? The young Mr Coase first grew interested in the workings of firms when he travelled around America's industrial heartland on a scholarship in 1931–32. He abandoned his textbooks and asked businessmen why they did what they did. He has long chided his fellow economists for scrawling hieroglyphics on blackboards rather than looking at what it actually takes to run a business. So it seems reasonable to test his ideas by the same empirical standards.

Mr Coase's theory continues to explain some of the most puzzling problems in modern business. Take the rise of vast and highly diversified business groups in the emerging world, such as India's Tata group and Turkey's Koc Holding. Many Western observers dismiss these as relics of a primitive form of capitalism. But they make perfect sense when you consider the transaction costs of going to the market. Where trust in established institutions is scarce, it makes sense for companies to stretch their brands over many industries. And where capital and labour markets are inefficient, it makes equal sense for companies to allocate their own capital and train their own loyalists.

But Mr Coase's narrow focus on transaction costs nevertheless provides only a partial explanation of the power of firms. The rise of the neo-Coasian school of economists has led to a fierce backlash among management theorists who champion the "resource-based theory" of the firm. They argue that activities are conducted within firms not only because markets fail, but also because firms succeed: they can marshal a wide range of resources – particularly nebulous ones such as "corporate culture" and "collective knowledge" – that markets cannot access. Companies can organise production and create knowledge in unique ways. They can also make long-term bets on innovations that will redefine markets rather than merely satisfy demand. Mr Coase's theory of "market failure" needs to be complemented by a theory of "organisational advantages".

All this undoubtedly complicates "The Nature of the Firm". But it also vindicates the twin decisions that Mr Coase made all those years ago as a young student at the London School of Economics: to look inside the black box rather than simply ignoring it, and to examine businesses, not just fiddle with theories. Is it too much to hope that other practitioners of the dismal science will follow his example and study the real world?

December 2010

Exit Albert Hirschman

A great lateral thinker died on December 10th 2012

ALBERT HIRSCHMAN knew what he was talking about when he called one of his books *Essays in Trespassing*. He was an extraordinarily peripatetic practitioner of the dismal science. Born in Berlin in 1915, he fled the Nazis in 1933, studied in Paris, London and Trieste, joined the anti-Mussolini resistance, fought on the Republican side in the Spanish civil war, served in the French army until France's collapse in 1940, helped to organise an "underground railway" for refugees, emigrated to America, joined the army and was a translator at Nuremberg. He applied the cosmopolitan spirit that he had acquired in these years to everything he wrote.

He made his reputation as a development economist, focusing on Latin America, but he soon found himself trespassing obsessively – not only into other sub-disciplines such as the theory of the firm but also into other disciplines entirely such as political science and the history of thought. Mr Hirschman was never awarded the Nobel prize in economics he so richly deserved, perhaps because his writing was hard to classify. However, as if by way of recompense, Princeton University Press has published a 768-page biography by Jeremy Adelman.

Mr Hirschman's most famous book, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations and States*, remains as suggestive today as it was when it first appeared in 1970, for managers and policymakers as well as intellectuals. Mr Hirschman argued that people have two different ways of responding to disappointment. They can vote with their feet (exit) or stay put and complain (voice). Exit has always been the default position in the United States: Americans are known as being quick to up sticks and move. It is also the default position in the economics profession. Indeed, when his book appeared, Milton Friedman and his colleagues in the Chicago School were busy extending the empire of exit to new areas. If public schools or public housing were rotten, they argued, people should be encouraged to escape them.